FROM THE
FOUNDER

Ben Bernanke's 2 a.m. Phone Call

BERNANKE: Who is this? It's two in the morning! Oh, Mr. President. Congratulations on killing bin Laden.

OBAMA: Yeah, but I'm really worried about the economy. QE2's worked; market's up nearly 15 percent, but …

BERNANKE: Don't bank too much on further help from the Fed, Mr. President. The era of free money is almost over. In the first quarter, we printed $504 billion new dollars. Got a miserable $34 billion jump in GDP. We'll keep interest rates low for a while longer, but that's killing the dollar and helping commodity prices soar. In a speech, the New York Fed president tried to argue that core inflation's still low—the price of an iPad's dropped. Someone in the crowd yelled: "We can't eat iPads."

OBAMA: So our long bond's in trouble?

BERNANKE: Here's the thing: The world's public and private debt's a whopping 300 percent of GDP. We hold a lot of it. Central banks can't prop up debt markets forever. The risk is a downward worldwide adjustment—a global mark-to-market—in living standards and a crashing dollar.

OBAMA: Whoa, let's back up. Isn't the weak dollar helping our exporters?

BERNANKE: Sure, for a while, and some dollar weakening allows foreigners to buy lots of our stuff here—hotels, stocks, land, even Park Avenue apartments—at attractive valuations. But if investors conclude the weak dollar will lead to higher inflation, watch out. They'll fear their dollars could lose both global and domestic purchasing power. The greenback could go into freefall. Assuming we don't have a double dip, our interest rates could soar.

OBAMA: Aren't you exaggerating?

BERNANKE: Some analysts think the dollar has already crossed the Rubicon. When the financial crisis hit, global investors poured into U.S. Treasuries as a safe haven. The dollar strengthened. But since then, look at the response to Libya, Tunisia, and Egypt. All the traditional safe-haven assets strengthened: oil, gold, the yen, the Swiss franc, even the euro, but not the dollar.

OBAMA: What's this mean?

BERNANKE: It means at least two things—the world suspects I don't have the guts to preemptively fight inflation (they're wrong)—and that you have no strategy for getting our GDP out of the basement. Ultimately, the world thinks we're going to let inflation eat up our debt and sell out our creditors.

OBAMA: That's ridiculous.

BERNANKE: Look at the numbers. As a result of the financial crisis, U.S. median household net wealth

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W., Suite 740
Washington, D.C. 20006
Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

dropped by 20 percent to $98,000. Median household income is barely $50,000. These aren't big numbers. What'll you tell these people as they approach retirement? That they have to give up everything so that the Chinese can receive their interest payments on our debt? And you and I both know there aren't enough wealthy taxpayers to avoid an entitlement nightmare.

OBAMA: You're depressing me.

BERNANKE: With all due respect, you and Congress aren't helping. Washington's become so fixated on how to divide up the pie, we've forgotten how to grow the pie. In the decade of the 2000s, we grew by less than 2 percent a year.

OBAMA: Yeah, but do you economists have any idea why? Have Americans run out of ideas? Of nerve? Of credit? Is there too much debt? Not enough stimulus? Are we at the end of some strange cycle mired in overcapacity? How do we get outta this mess, Ben?

BERNANKE: Two things, and I admit I'm playing devil's advocate here. First, we need to think defensively. China's experiencing double-digit inflation. Beijing knows that food price hikes were the spark that produced revolution in Tunisia and Egypt. The Chinese'll try desperately to slow down their economy but, at the same time, to avoid a hard landing.

OBAMA: But what if they land hard? The bubble bursts?

BERNANKE: The situation would make TARP look like child's play. They'd have to recapitalize their banking system. Would they sell their U.S. Treasuries, or hand them over to the banks? And could the banks then sell the Treasuries? No one knows. That's why everyone—even the Europeans and the IMF—is talking about capital controls and other administrative barriers. When the pie is shrinking, everybody will manipulate for advantage. But get this: in such a scenario, the whole world could pour into our Treasury market as a safe haven. Interest rates would fall, but not necessarily for a good reason. The same development could take place if the European sovereign debt crisis blows up.

OBAMA: And the second thing?

BERNANKE: Think growth, Mr. President. Think bigger pie. Bigger at least gives us a chance. Here's a plan. I'll make this clear: That despite our dual mandate, the Fed understands that given our debt, an inflation spike could spell the beginning of the dollar's end, with much higher interest rates. Meanwhile, you develop a bipartisan growth strategy. Reform the tax code. Address the problem of shrinking risk capital that's retarded job creation. And strike a credible deal on entitlements. Europe's ahead of us on this, and time's running out. Europe's regulators are already warning their banks not to buy risky U.S. Treasury bonds. The S&P shot across the bow was the first public sign of growing global market skepticism … toward us. That is, unless the entire world comes into question. Then, like the least ugly contestant in the Ugly Person Beauty Contest, global liquidity could ironically flood into Treasuries. But that's not a prize we want to win.


OFFICIAL WHITE HOUSE PHOTO BY PETE SOUZA

OBAMA: This is all a bit too confusing.

BERNANKE: You can say that again, Mr. President.

—DAVID Smick
Founder and Editor of TIE, *and author of* The World Is Curved: Hidden Dangers to the Global Economy